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An evaluation of indirect cost rate determination at the Naval Postgraduate School

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Monterey, California. Naval Postgraduate School

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NAVAL POSTGRADUATE SCHOOL

MONTEREY, CALIFORNIA

MBA PROFESSIONAL REPORT

An Evaluation of Indirect Cost Rate Determination at the Naval Postgraduate School

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By: Brant Clark,
Michael J. Jones, and
Wendy J. Miller
December 2004

Advisors: Joseph G. San Miguel
Don Summers

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13. ABSTRACT *(maximum 200 words)*

Since its inception, faculty of the Naval Postgraduate School (NPS) have conducted research and development for the United States Navy, its sister military services, and other various agencies spread across the federal government. For its support of research efforts, NPS is reimbursed for actual costs incurred in association with providing research and development. Over the past several years the school has experienced a significant increase in the amount of reimbursable program dollars coming into the school. Recently, school administrators questioned whether reimbursement rates charged to research customers accurately reflected the actual cost incurred in providing the service. In 2003, NPS commissioned PricewaterhouseCoopers (PwC), a professional consulting firm, to study the current rate structure and make recommendations as to what rates NPS should charge for reimbursable research and education. PwC's final report was submitted to the school in the spring of 2004. The purpose of this research project is to analyze their final report to understand the methodology and procedures PwC used to determine rates, and determine if the rate structure proposed by PwC is appropriate for implementation at NPS.

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AN EVALUATION OF INDIRECT COST RATE DETERMINATION AT THE NAVAL POSTGRADUATE SCHOOL

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Submitted in partial fulfillment of the requirements for the degree of

MASTER OF BUSINESS ADMINISTRATION

from the

NAVAL POSTGRADUATE SCHOOL
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AN EVALUATION OF INDIRECT COST RATE DETERMINATION AT THE NAVAL POSTGRADUATE SCHOOL

ABSTRACT

Since its inception, faculty of the Naval Postgraduate School (NPS) have conducted research and development for the United States Navy, its sister military services, and other various agencies spread across the federal government. For its support of research efforts, NPS is reimbursed for actual costs incurred in association with providing research and development. Over the past several years the school has experienced a significant increase in the amount of reimbursable program dollars coming into the school. Recently, school administrators questioned whether reimbursement rates charged to research customers accurately reflected the actual cost incurred in providing the service. In 2003, NPS commissioned PricewaterhouseCoopers (PwC), a professional consulting firm, to study the current rate structure and make recommendations as to what rates NPS should charge for reimbursable research and education. PwC's final report was submitted to the school in the spring of 2004. The purpose of this research project is to analyze their final report to understand the methodology and procedures PwC used to determine rates, and determine if the rate structure proposed by PwC is appropriate for implementation at NPS.

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I. INTRODUCTION

A. BACKGROUND

Since its inception in the early 20th century, the Naval Postgraduate School (NPS) has a long history of providing graduate level education to Naval and Marine Corps officers. In addition to education, research and development conducted by the school's faculty have yielded numerous technological advances and significantly impacted the way the Navy and Marine Corps operate in defense of our country. Over the last several years, that research and education mission has transcended beyond the ranks of the Navy and Marine Corps. Today, officers and civilians from all branches of the Department of Defense, as well as several other federal agencies and many allied nations, receive graduate level education at NPS. Research and development conducted at the school has expanded exponentially over the last 50 years. In 1955, reimbursable research amounted to only $30 thousand; in fiscal year (FY)02 it was $57 million; $66 million in FY03, and $83 million in FY04. Today, the amount of reimbursable program dollars, including research and education, flowing into the school far exceeds what the school receives in appropriated funds from the Department of the Navy (DON).

Noting the increasing trend in reimbursable program funds received by the school's faculty, NPS administrators questioned whether rates charged to sponsoring organizations were adequately capturing the costs incurred by the school in support of research programs. In 2003, the school commissioned PricewaterhouseCoopers (PwC), a professional consulting firm, to study the school's reimbursable programs and submit Facilities and Administrative (F&A) rate proposals that more accurately reimburse the school for actual costs incurred in support of the research and education programs. In March 2004, PwC submitted its final report, including new F&A rate proposals.

B. PURPOSE

A comprehensive review of the PwC report clarifies the methodology and procedures PwC used to determine the proposed F&A rates. After gaining a complete

understanding of the rate proposals, a determination will be made to the applicability of PwC's recommendations to the NPS.

C. RESEARCH QUESTIONS

1. Are the F&A rate proposals submitted by PwC applicable to NPS?

2. The report uses OMB Circular A-21, "Cost Principles for Education Institutions", as its governing regulation. Did PwC follow A-21 guidelines to determine federal payments to civilian research universities with contracts or awards?

3. What cost allocation methods did PwC use and are they appropriate?

4. Is OMB Circular A-21 applicable to NPS?

5. How has NPS been charging DoD and non-DoD agencies in the past?

6. Are there costs not covered by appropriations? If so, are they the direct result of reimbursable research or education programs and how should they be gathered and allocated to their activities?

D. BENEFITS OF THE STUDY

First, this study will help to provide a better understanding of how PwC conducted the study, and provide further validation of the data and procedures used to make the rate recommendations. Secondly, this study will provide insight and understanding as to its applicability from a DoD financial management perspective.

E. SCOPE AND METHODOLOGY

1. Scope

This analysis focuses on the final report submitted to NPS by PwC, including how PwC arrived at its recommendations, the appropriateness of regulatory guidance used, and the applicability with regards to the DoD Financial Management Regulations

(DoDFMRs). Final recommendations are offered to the school on appropriate actions to take based on the final PwC report.

2. Methodology

Research included a comprehensive review of the PwC final report. An extensive literature review was conducted of the OMB A-21, DoDFMRs, DoD regulations governing inter and intra agency support, and U.S. Comptroller General decisions to determine precedence. Interviews were conducted with NPS personnel intimately familiar with the history behind reimbursable programs and why PwC was engaged to perform the study.

F. ORGANIZATION OF STUDY

Chapter II analyzes the reimbursable research process prior to the PwC study and identifies the underlying problem(s) that necessitated the hiring of PwC. Chapter III analyzes the PwC proposal, providing a clearer understanding of its recommendations and how they were derived. Chapter IV contains a literature review focusing on the OMB A-21, the DoDFMRs, U.S. Comptroller General decisions, and other applicable federal regulations. Chapter V outlines conclusions and recommendations resulting from the research.

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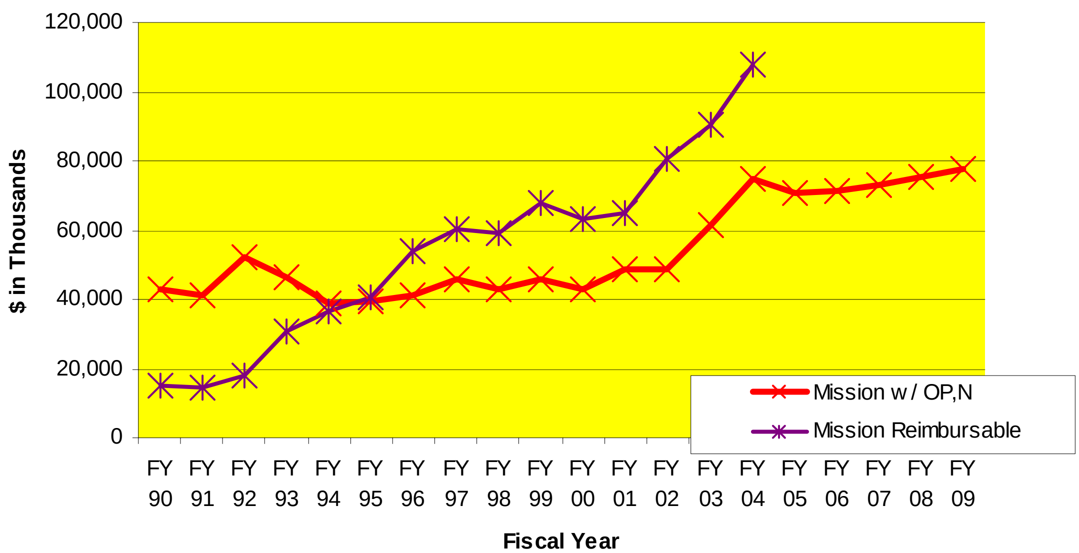
II. NAVAL POSTGRADUATE SCHOOL (NPS) INDIRECT COSTS FOR REIMBURSABLE RESEARCH PROJECTS

A. OVERVIEW

The Naval Postgraduate School faculty has not always been active in research activity. However, starting in 1970, the level of research and reimbursable projects sponsored by external organizations has risen dramatically. In FY90 the reimbursable research projects reached over $16M and for FY04 they are well over $100M, as evidenced in Figure 1.

Figure 1. NPS Resource History



Reimbursable funding exceeded appropriated funding by $22M in fiscal year 2004. Because of such growth in these externally funded programs and the likelihood of continued growth, it was, and will continue to be, necessary to study and review collection processes for establishing indirect cost recovery rates. The first major review occurred in 1981 after an audit by the Naval Audit Service was conducted on NPS. Several reviews and updates have occurred between 1981 and the present. A Faculty Ad

Hoc Committee on Indirect Costs appointed by the school's Provost is conducting the latest review and study.

B. FIRST MAJOR REVIEW ON PROCESSES AND RATES

In early 1981, Naval Audit A10110/A10100 was conducted on the Naval Postgraduate School. In response to this audit, it was decided that the office of the Comptroller of the Navy (NAVCOMPT) would review the definitions of indirect costs related to research projects at NPS and develop guidance and procedures to collect these costs as reimbursements from research sponsors.

Accordingly, the NAVCOMPT reviewed research functions at NPS and came up with new guidance and procedures for allocating indirect costs to reimbursable research projects at NPS. NAVCOMPT used Comptroller General Decision B 136318, 14 August 1978, as reference. This decision states, in part, that indirect costs associated with reimbursable efforts may be recovered if it can be shown that they benefit the agency requesting such efforts, and that these indirect costs would not have been incurred by the performing agency in the absence of such reimbursable effort.

1. Procedures for Establishing Indirect Costs at NPS

Indirect costs are defined as contributing to the reimbursable effort but not funded directly by the sponsor because these costs are small per project and difficult to measure and account for without considerable administrative effort. Indirect costs incurred for the benefit of research projects are indirect labor costs, indirect non-labor costs, and indirect Bid and Proposal (B&P) costs.

Indirect Labor Costs incurred for conducting and administering research projects are identified by NPS departments and organizational units listed in Figure 1 (Note: this list dates to 1981; The Department of Admin Science is now the Graduate School of Business and Public Policy.) Indirect labor costs are those labor costs not directly attributable to any certain program. However, functions identifying these costs must have a significant relationship to performing reimbursable research projects. This

information is surveyed and gathered annually in order to measure the cost of the indirect labor effort. The ratio of indirect labor costs to direct labor costs performed on research projects is used to establish the applicable Indirect Labor Rate. The survey is made annually and an Indirect Labor Rate is established each year and used in all research proposals for the subsequent fiscal year.

Indirect Non-Labor Costs are identified through submission of a budget by the departments and organizational units listed in Figure 2. Items that are suitable and qualify as indirect non-labor costs include the following:

a. Supplies and equipment

b. Travel subsequent to availability of project funds

c. Page publication charges accrued subsequent to completion of project

d. Repair of laboratory equipment

e. Charges for long distance telephone calls of an incidental nature

f. Copy paper

Indirect Bid and Proposal (B&P) Costs that can be recovered include items and effort necessary for preparing sponsored research proposals and for demonstrating such capability in a given area. These costs are estimated and submitted by each department and organizational unit listed in Figure 2. These items include:

a. Faculty Salaries to the extent they may be utilized to perform preliminary minor investigations or write proposals for sponsored support

b. Support Staff Salaries to the extent they are utilized in support of preliminary efforts to obtain sponsored support

c. Laboratory Equipment (unit cost less than $10,000, 1981 dollars) use by several users and/or necessary to demonstrate feasibility

d. Departmental Supplies related for research effort

e. Travel

f. Miscellaneous

Total Indirect Cost Rate is composed of two rates: 1) Indirect Labor Rate and 2) Indirect Non-Labor and Indirect Bid and Proposal (B&P) Rate (not to exceed 10% of the total direct labor costs identified for reimbursable research projects). Total Indirect Rate is expressed as a percentage of the total proposal direct labor cost for each sponsored project for a given fiscal year.

2. Change to NAVCOMPT Manual

After developing procedures for allocating indirect costs to the reimbursable projects at NPS, the Navy Accounting and Finance Center (NAFC) approved and added the following to the end of Par. 035807-2h(3), NAVCOMPT Manual, Volume 3:

> The Naval Postgraduate School, Monterey, CA is exempt from this policy and is authorized to recover indirect costs incurred that are significantly related to reimbursable research projects by means of applying an indirect cost rate based upon the direct labor cost. The total amount of these indirect costs applicable to each project will be stated in the budget page of each bid and proposed together with a brief explanation statement. The recovery of significant costs will be in accordance with par. 075120-3, which required such costs to be additional, identifiable, and segregated on a reasonable and meaningful basis. The Naval Postgraduate School is required to follow procedures authorized by the Comptroller of the Navy for allocating indirect costs to reimbursable research projects.

Figure 2. Departments and Organizational Units Authorized to Allocate Indirect Costs which significantly support Reimbursable Research Projects (1981)

Activity Code	Department Name
012	Research Office
52	Department of Computer Science
53	Department of Mathematics
54	Department of Admin Science
55	Department of Operations Research
56	Department of National Security Affairs
61	Department of Physics & Chemistry
62	Department of Electrical Engineering
63	Department of Meteorology
64	Defense Resources Management Ed Center
67	Department of Aeronautics
68	Department of Oceanography
69	Department of Mechanical Engineering
71	ASW Academic Group
73	Electronic Warfare Group
74	C3 Academic Group

C. PROPOSED CHANGE TO FINANCIAL MANAGEMENT REGULATIONS (FMRS)

NPS relied on NAVCOMPT Manual for guidance and reference to recover indirect costs for reimbursable research projects. In a letter dated 24 May 2002, the Department of the Navy, Office of the Assistant Secretary (Financial Management and Comptroller), cancelled several Navy Manuals. Included in the list of manuals was NAVCOMPT Manual, Vol 3. These manuals were cancelled in support of the effort by the Under Secretary of Defense (Comptroller) to review all existing financial

management guidance issued by the Office of the Secretary of Defense and the Military Departments to eliminate or incorporate as much as possible into the Department of Defense Financial Management Regulations (FMRs).

The NAVCOMPT Manuals had not been maintained since the creation of the Defense Finance and Accounting Service (DFAS) back in the early 1990's, consequently, most of them were outdated. The Department of the Navy felt it would be an enormous effort to review and update these manuals, so they opted to cancel them and address only the necessary guidance contained in these manuals on an exception basis.

Each manual identified on the list was going to be officially canceled and discontinued effective 30 September 2002. DON asked all affected agencies to forward a request if there was any pertinent information in these manuals that needed to be retained and promulgated in a DON specific manual or DON annex to the FMR. On 31 July 2002, the Superintendent of the Naval Postgraduate School forwarded a letter to Principal Deputy Assistant Secretary of the Navy (Financial Management and Comptroller) requesting to retain the subject guidance in NAVCOMPT Manual, Volume 3 that allowed NPS to recover indirect costs in support of reimbursable research projects. After awaiting a reply for a year, the Superintendent of NPS forwarded another letter on 7 May 2003 asking for a status on the request to retain guidance. Additionally, the letter stated that unless otherwise directed, NPS would continue to recover indirect costs on reimbursable research.

To date, the FMRs have not been updated to show the requested language allowing NPS to recover indirect costs in support of reimbursable research projects. As it stands now, DoD FMR, Vol. 11A, Section 030601 in principle states the following reimbursement policy:

> The requesting agency must pay the servicing agency the actual costs of the goods or services provided. Actual costs include all direct costs attributable to providing the goods and services, regardless of whether the servicing agency's expenditures are increased. Actual costs also include indirect costs (overhead) to the extent they have a significant relationship to providing the goods or services and benefit the requesting agency. *DoD activities not funded by working capital funds normally do not charge indirect costs to other DoD activities*.

D. FACULTY AD HOC COMMITTEE ON INDIRECT COSTS

There have been several reviews and adjustments to the indirect cost rates on reimbursable research projects since the review in 1981. For example, in 1986 NPS asked NAVCOMPT for authority to increase the indirect cost rate from 22% of the direct cost labor portion of a proposal to between 30% and 32%. Basically, NPS wanted to add the following non-academic departments to the list of departments and organizational units that were already authorized to allocate indirect costs to reimbursable research projects (Figure 2): 1) Comptroller 2) Supply Division 3) Educational Media 4) Civilian Personnel 5) Library and 6) Computer Center. Finally, on 9 April 2001, the Provost appointed a Faculty Ad Hoc Committee on Indirect Costs to review the current rate that had been in effect since 1 October 1996. This was necessary in light of the growth in sponsored programs over the past few years. This was also necessary because, as stated earlier, the Department of the Navy decided to cancel and discontinue NAVCOMPT Manual, Volume 3.

The Faculty Ad Hoc Committee on Indirect Costs was comprised of a representative from each of the four schools, an Institute representative, and an at-large representative. The Provost directed the Faculty Ad Hoc Committee to work in conjunction with three principal advisors, Dean of Research, Associate Provost for Academic Affairs, and the Director of the Research and Sponsored Programs Office, to review indirect cost policies and processes for reimbursable research projects at NPS. The Committee recommended the establishment of interim rates pending completion of a study on facilities and administration (indirect costs) rate for sponsored programs to be performed by PricewaterhouseCoopers (PwC). The interim indirect costs rates effective 1 October 2003 were:

Research:

On Campus: 23%

Off Campus: 13.75%

Instruction:

On Campus: 17%

Off Campus: 6%

1. PricewaterhouseCoopers (PwC) Study

In September 2003, PricewaterhouseCoopers was awarded a contract to assist the NPS administration in the establishment of facilities and administration indirect cost rate for research sponsored programs. The Office of Naval Research (ONR) determined that PwC would use OMB Circular A-21, Cost Principles for Educational Institutions, as a guide to perform the study since NPS is an educational institution. This Circular establishes principles for determining costs applicable to grants, contracts, and other agreements with civilian educational institutions, and applies to all Federal agencies that sponsor research and development, training, and other work at these institutions.

PwC completed the study on 31 March 2004 and results were briefed to the Ad Hoc Committee, Research Board, Deans and Chairs, Provost and Superintendent. The Committee proceeded to meet on a regular basis to review the PwC study. Some concerns addressed by the Committee members included the legality of recovery (FMR states that DoD will not collect indirect costs from other DoD entities), validity of guidance (OMB A-21 governs civilian institutions, NPS is a DoD entity), validity of data (question of oversight in designation of costs to cost pools), and overall increase in rates (all rates computed by PwC were considerably higher than current rates, especially for reimbursable instruction rates).

Committee members, advisors, and other university personnel discussed the above concerns at length. As to the legality or recovery, appropriate actions had been taken by NPS administration to request the addition of NAVCOMPT Manual guidance to the FMR. To date, the FMRs have not been updated; there is only a verbal approval from the Office of Assistant Secretary of the Navy (FM&C) to continue the recovery of indirect costs against reimbursable research programs. The use of OMB A-21 was discussed with FMB policy officials and the ONR and selected as appropriate guidance. The ONR deals primarily with civilian research universities and is, therefore, familiar and supportive of A-21. However, they have no authority at NPS. The applicability of the A-21 to NPS is furthered discussed in Chapter IV. The Director of the Research and Sponsored Programs Office and NPS Comptroller oversaw the collection of data by PwC.

2. Proposed New Rates

The committee recommended Facilities and Administration rates for FY05 and FY06. These rates will be collected against labor costs (faculty, staff, and contract) for two years until a review of the proposed indirect rate is made by a faculty committee, an appropriate space survey of facility use is completed, and an accounting system for recording modified total direct costs (MTDC) is in place.

The committee's approach was to use the PwC study as the foundation and guidance to establish the indirect cost rates for reimbursable research and education projects at NPS. They relied heavily on the study's findings as a framework for identifying and understanding the school's facilities and administration categories and subcategories, and actual costs within these categories. They also used the study as an initial benchmark for specific indirect cost rates appropriate for reimbursable research activities.

The committee made adjustments to the PwC rates based mostly on three factors. First, there were particular identifiable aspects of the PwC study that challenge a direct use of the study's findings. For example, there was a lack of details in the NPS space records that caused a disproportionate allocation of costs to resident instruction versus research. Second, they took into consideration the uniqueness of NPS, which is a federally funded university with military faculty and personnel. Faculty members are not completely compensated by NPS for the pursuit of scholarly activity, i.e. research. Finally, there are causal and beneficial relationships. The committee examined the detailed categorization of indirect costs provided by PwC study and adjusted some of the rates where an absence of causal or beneficial relationships existed. Figure 3 shows the rate comparisons of PwC study and the committee recommendations.

Figure 3. Rate Comparison Between PwC Study and Committee Recommendations

Components		Committee		PwC Study	
Activity	**Sponsor**	**On-Campus**	**Off-Campus**	**On-Campus**	**Off-Campus**
Research	Navy	21.59	19.43	23.59	21.43
	DoD	30.59	19.43	41.01	21.43
	Non-DoD	30.90	19.78	43.34	22.95
Instruction	Navy	19.23	19.23	39.80	32.00
	DoD	26.03	19.23	63.41	32.00
	Non-DoD	29.29	20.82	57.99	26.00
Other Sponsored Activities	Navy	16.82	16.82	19.67	18.82
	DoD	26.67	17.63	39.67	18.82
	Non-DoD	26.67	17.63	43.23	20.80

Reimbursable activities are classified as sponsored if the activity is funded by an external organization. There are three general categories of sponsored projects: Sponsored Research, Sponsored Instruction, and Other Sponsored Activity (OSA). *Sponsored Research* activities include the rigorous inquiry, experiment or investigation to increase the scholarly understanding of the involved discipline. Some examples include:

- Awards to NPS faculty to support research activities, basic or applied
- External funding to maintain facilities or equipment used for research
- External support for writing of books with research results
- External faculty “career awards” to support research efforts by faculty
- Funding for Chair Professorships
- Cooperative Research and Development Agreements

Sponsored Instruction includes curriculum development as well as all types of teaching and training activities offered for credit towards a degree or certificate. Some examples include:

- Any project for which the purpose is to instruct any student at any location
- Curriculum development projects at any level
- Activities funded for the support of students, i.e. SPAWAR fellowships, experience tours, and thesis support
- General support for the writing of textbooks or reference books, video, or software to be used as instructional material

Other Sponsored Activity (OSA) are activities defined as academic projects funded by sponsors in which project activities involve the performance of work other than sponsored instruction or research. These activities may include:

- Travel only grants
- Support for conferences or seminars
- Programs to enhance institutional resources
- Support for projects pertaining to library collections or acquisitions
- Technical Service Agreements
- Intergovernmental Personnel Act Agreements

These projects or activities can also be classified as On-Campus or Off-Campus. A project is considered to be performed off-campus if the activity is conducted at a location other than NPS. Sponsored instruction programs for distance learning are considered off-campus. Projects conducted partially off-campus will be considered off-campus if more than fifty percent of the work is conducted at a location other than NPS and the total annual budget is less than $100,000. If the annual budget is greater than $100,000, the rate will be apportioned between the on-campus and off-campus rates according to the place of performance. If the lesser component is less than twenty percent, the entire project will be charged to the rate of the larger component.

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III. PRICEWATERHOUSECOOPERS ANALYSIS

A. OVERVIEW

PricewaterhouseCoopers (PwC) was contracted by NPS to conduct a rate proposal of the school's Facilities and Administrative (F&A), or indirect, rates for use in determining appropriate reimbursement rates. Temporary rates used by NPS for fiscal years 2002 through 2004 were 23% for all on-campus activities and 13.75% for all off-campus activities, pending an outside study. These rates are based on total direct labor costs. From 1990 to 2004, NPS significantly increased the amount of reimbursable programs, from $16M to $107M. A review of these rates is necessary to properly recoup funds for costs incurred to support reimbursable activity. It is essential to appropriately determine indirect rates to prevent augmentation of appropriated funded activities as well as to ensure that sponsors do not subsidize F&A costs of other sponsors.

PwC, a professional consulting organization, was hired to conduct the cost analysis because of the complexity of the reimbursable programs. The PwC consultants had no prior experience with directly funded federal organizations, but were very experienced with civilian universities. Their report did not include an audit of the information provided by NPS. All financial estimates provided are based upon the information provided by NPS for fiscal year 2003. Space costs were determined based on a Base Realignment and Closure data call from 2004.

B. PWC USE OF OMB CIRCULAR A-21

The purpose of the OMB Circular A-21 is to provide "principles for determining costs applicable to grants, contracts, and other agreements with educational institutions. The principles are designed to provide that the Federal Government bear its fair share of total costs, determined in accordance with generally accepted accounting principles, except where restricted or prohibited by law. Provision for profit or other increment above cost is outside the scope of this Circular." These principles are applicable to those

colleges and universities under sponsored agreements and are similar to the Cost Accounting Standards for defense contractors.

- Direct costs are those that can be directly attributed to a particular activity or that can be directly assigned to such activities easily and accurately.
- F&A costs are those incurred for a common or joint objective and cannot be directly attributed to a specific activity.
- "Facilities" is defined as depreciation, interest on debt, equipment, capital improvements, operation and maintenance (O&M) expenses, and library expenses. For the NPS, only O&M and library expenses are applicable. Depreciation and interest costs, ordinarily included in the "Facilities" category of F&A costs, do not exist because the military purchases their facilities.
- "Administrative" costs are defined as general administration and general expenses, departmental administration, sponsored projects administration, student administration and services, and all other costs not under the "Facilities" category or its subcategories.

C. COST ALLOCATION

Financial data for the DoD fiscal year, ending September 30, 2003 was used in determining the F&A rates. PwC's objective was to accurately distribute indirect costs to "the major functions of the institution in proportions reasonably consistent with the nature and extent of their use of the institution's resources." To do so, all costs must be categorized as direct or indirect and allocated to applicable cost pools. The costs, in all circumstances, must either be direct costs or indirect (F&A) costs only and consistently applied to the cost pools. Each of these cost pools is assigned a rate based on their modified total direct costs (MTDC). This includes all salaries and wages, fringe benefits, materials and supplies, services, travel, and the portion of each subgrant and subcontract up to $25K. The rate is the percentage of the F&A cost pool to the modified total direct cost of that cost pool.

$$Rate = \frac{F\ \&\ A\cos ts}{MTDC} x100\%$$

This consistency ensures the integrity of the allocation base, MTDC, and therefore, the integrity of the rates.

1. Major Functions and Cost Pools

The major functions for the F&A rates are instruction, research, and other sponsored activities for on-campus and off-campus. PwC proposed rates for each of these major functions for the NPS. Further subjugation of these major functions is necessary to match costs from the accounting system to these major functions. This subjugation of the major functions yields cost pool groups. According to section F of the OMB A-21, the F&A cost pool groups, excluding depreciation and interest, are categorized as:

- Facilities:
    - Operations and Maintenance (O&M)
    - Library
- Administrative:
    - General Administration and General Expenses (G&A)
    - Departmental Administration (DA)
    - Sponsored Projects Administration (SPA)
    - Student Administration and Services (SAS)

O&M expenses include those incurred for the administration, operation, maintenance, preservation, supervision and protection of the NPS facilities and grounds. Library expenses are for the cost of books and materials less any items of library income that qualify as applicable credits. G&A expenses are for general executive and administrative offices and other expenses that do not relate solely to any major function. The administrative offices should serve the entire institution, including the Comptroller, Personnel, Safety, and Staff Judge Advocate offices. DA expenses are similar to G&A,

except that they are for common or joint departmental activities in academic deans' offices, academic departments, and organized research units. SPA expenses are those incurred by organizations primarily established to administer sponsored projects, including salaries of the head, staff, assistants, and other personnel, contract administration, purchasing, personnel, and administration. SAS costs are those incurred for the administration of student affairs, such as admissions, the registrar, and student advisors.

2. Unique Features of NPS Involved in the Rate Determination Process

PwC's report contains two volumes to delineate the rates – Volume 1 for those federal agencies not reporting to the DoD and Volume 2 for those reporting to the DoD. The distinction between these two volumes is the inclusion and exclusion of military labor, respectively. Since the DoD pays military personnel, those agencies reporting to the DoD may not include these costs in the rate calculations.

As noted in PwC's introduction, "NPS is subject to Public Law 31 USC 1301, which requires that appropriated funds be used only for programs and purposes for which the appropriation is made. Under that public law, NPS is prohibited from subsidizing any outside projects or programs. As such, rates must be developed in a way that ensures that allocable indirect costs are properly assigned to each so that outside projects and programs can be charged for their full share of direct and indirect costs." While this satisfies government fiscal law, it conflicts with guidance set forth in the DoD Financial Management Regulations in regards to collecting indirect costs, which is expounded in Chapter IV. Additional analysis was required to ensure all costs were properly assigned to the appropriate fiscal year due to the complexity of the Navy's accounting system. There is no depreciation involved as all buildings and equipment are funded directly by the Navy. Likewise, no interest charge is incurred. Certain costs are unique to NPS as a military facility and strictly exist because of its military purpose. Therefore, these costs are excluded from the calculations and are categorized as General Administration – Other Institutional Activities or Other Institutional Activities.

3. Stepdown Allocation Process

The first step in determining rates is to acquire the school's financial downloads for fiscal year 2003. These figures were then decreased by the amount of exclusions due to applicable credits, capital expenditures, payments for leave benefits, space rent, subcontracts greater than $25 thousand, system adjustments, and tuition and fees. From here, the figures were distributed between the A-21 cost pools as described in section D. Of the $215 million from the financial download, $182.7 million was allocated to the cost pools. The $182.7 million is known as the modified total direct costs.

The next step was to make adjustments to eliminate duplicate charges between the cost pools. Funds were transferred from Instruction to DA for non-labor costs, salaries, and fringe benefits. Military personnel costs were added here for federal agencies not under the DoD. Other required adjustments included the elimination of unallowable costs. Unallowable costs are identified in section J of the OMB A-21. These costs "cannot be included in prices, cost reimbursements, or settlements under a Government sponsored agreement to which it is allocable" and are therefore excluded from the billings to federal government agencies that support sponsored agreements. PwC identified unallowable costs for NPS in several ways. First, they identified through the accounting system unallowable activities or specific unallowable documents within accounts, as well as an analysis of year-end accounts with the potential for including unallowable amounts. Secondly, PwC identified unallowable activities as described in OMB Circular A-21. They identified activities funded by the NPS operating budget, such as operations of housing facilities, and are so identified in the accounting records. And lastly, a scrub of allowable activities for transactions including unallowable expenses was conducted. Each transaction was retraced to its assigned object codes that classify its expense category in the accounting system.

At this point, the F&A costs are distributed to the direct cost functions – Instruction, Research, OSA, and Other Institutional Activities (OIA) via a stepdown allocation IAW OMB A-21. This is explained in further detail in D1 and 2.

D. F&A RATES

Three different bases were used in calculating rate components -- all-campus, on-campus, and sponsored. The all-campus base includes projects that take place either on or off campus. The on-campus base includes only those projects taking place on campus. The sponsored base includes projects supported by the Research and Sponsored Programs office. Facilities components, O&M and Library, utilized the on-campus base. The SPA cost pool utilized the sponsored base as only sponsored programs benefit from the SPA component. All other Administration cost pools utilized the all-campus base. Figure 4 represents a summary of PwC's recommended F&A rates for non-DoD and DoD agencies by on- and off-campus Instruction, Research, and OSA rates per NPS-applicable F&A cost pools. The capped rate is only applicable to non-DoD agencies per the OMB A-21 and, for NPS, only affects the Instruction rate. All figures are expressed as percentages.

Figure 4. F&A Rate Schedule

	For Federal Agencies Not Reporting to DoD						*For Federal Agencies Under the DoD*					
	Instruction Rate		Research Rate		OSA Rate		Instruction Rate		Research Rate		OSA Rate	
Campus:	On	Off	On	Off	On	Off	On	Off	On	Off	On	Off
G&A	10.92	10.92	10.92	10.92	10.92	10.92	9.75	9.75	9.75	9.75	9.75	9.75
DA	11.25	11.25	9.55	9.55	7.42	7.42	11.02	11.02	9.21	9.21	6.63	6.63
SPA	0.49	0.49	2.48	2.48	2.46	2.46	0.53	0.53	2.47	2.47	2.44	2.44
SAS	10.33	10.33					10.70	10.70	0.00	0.00	0.00	0.00
Tot Admin Uncapped:	32.99	32.99	22.95	22.95	20.80	20.80	32.00	32.00	21.43	21.43	18.82	18.82
Tot Admin Capped:	26.00	26.00	22.95	22.95	20.80	20.80	26.00	26.00	21.43	21.43	18.82	18.82
O&M	24.52	0.00	18.27	0.00	21.60	0.00	23.61	0.00	17.42	0.00	20.00	0.00
Library	7.47	0.00	2.12	0.00	0.83	0.00	7.80	0.00	2.16	0.00	0.85	0.00
Total Facilities:	31.99	0.00	20.39	0.00	22.43	0.00	31.41	0.00	19.58	0.00	20.85	0.00
Total Facilities capped:	31.99	0.00	20.39	0.00	22.43	0.00	31.41	0.00	19.58	0.00	20.85	0.00
Total F&A uncapped:	64.98	32.99	43.34	22.95	43.23	20.80	63.41	32.00	41.01	21.43	39.67	18.82
Total F&A capped:	57.99	26.00	43.34	22.95	43.23	20.80	57.41	26.00	41.01	21.43	39.67	18.82

1. Rates for Facilities Components

For federal agencies not reporting to the DoD, off-campus rates for facilities are 0%. This is due to off-campus programs' non-utilization of the facilities on campus and therefore no indirect costs for O&M and the library are incurred.

a. Operations and Maintenance (O&M)

Several cost pools within O&M help to allocate these costs to the applicable A-21 cost pools. Cost pool 110, for campus-wide O&M costs, includes costs of facilities maintenance that benefit all NPS activities except for housing operations, which are a purely military function and included in OIA, and are measured by net assignable square footage. These costs are assigned to buildings based on the square footage and then assigned to cost pools based on the building's function. Cost pools 120 and 130 include public safety and communication costs based on full-time equivalent salaries and wages. These are allocated to all direct and F&A cost pools except O&M based on the percentage of salaries and wages assigned to them. Cost Pool 140 captures Engineering Laboratory maintenance costs that benefit DA, Instruction, Research, and OSA, and are allocated to those cost pools based on percentage of salaries and wages in those functions for the departments within the School of Engineering and Applied Sciences.

b. Library

Library costs are only allocated to direct cost functions, mainly to Instruction and Research. They are first allocated based on faculty/staff or student use on a full-time equivalent measure. All student costs are allocated to Instruction and faculty/staff costs are allocated among all three major functions based on salaries and wages of on-campus activities.

2. Rates for Administrative Components

All Administrative rates (G&A, DA, SPA, and SAS) are capped for other federal agencies at 26% of MTDC in accordance with OMB A-21 and uncapped for DoD agencies. These rates are equal between on- and off-campus categories.

a. General Administration (G&A)

G&A costs are allocated to all F&A and direct cost functions based on MTDC. Campus-wide G&A costs include the Superintendent, Public Affairs, Legal Costs, Strategic Planning, Human Resources, and Comptroller offices. G&A – OIA includes unallowable costs, the Chaplain's office, and a proportional share of O&M costs. All of these costs are allocated to the OIA cost pool. Expenses for the office of the Director of Programs, the Provost, Institutional Research/Accreditation, and Academic Planning fall under the G&A – Academic Administration cost pool. These costs are allocated based on the MTDC of academic departments and the library.

b. Departmental Administration (DA)

DA costs are allocated to direct cost functions only, based on MTDC. These costs consist of five major components: Administrative Labor, Calculated Non-labor DA costs determined using the Direct Charge Equivalent (DCE) methodology, Deans' Office Expenses, Calculated Faculty Administrative Allowance (FAA), and the stepdown portion of O&M and G&A costs. Administrative Labor is charged directly to the departments. Under DCE, certain administrative non-labor costs, such as postage and supplies, may be charged to sponsored projects as direct costs. The DCE methodology reduces the DA cost pool by the amount of support costs directly related to non-sponsored activities, to compensate for the costing inconsistency. A DCE ratio is calculated based on non-sponsored labor costs divided by sponsored salaries and wages (net of general support salaries and wages). This is multiplied by the non-sponsored salaries and wages less FAA salaries to determine the DCE adjustment. The actual non-sponsored non-labor costs less this DCE adjustment leaves allowable DA costs by department. If the DCE adjustment is greater than the actual costs, 100% of the costs are allocated to direct non-sponsored activity. FAA costs to academic departments are limited to 3.6% of the MTDC, excluding all other DA components, for salaries and fringe benefits attributable to the administrative work of faculty.

c. Sponsored Projects Administration (SPA)

SPA costs are allocated only to direct cost functions and is based on MTDC of sponsored projects. Instruction received 21.13% of SPA costs; Research received 78.13%; and OSA received 0.74%.

d. Student Administration and Services (SAS)

All SAS costs are assigned directly to the Instruction function since these costs are for the administration of student affairs and services.

E. DISCREPANCIES/CONCERNS

PwC conducted a thorough review of the NPS costing structure in determining proposed F&A rates; however we noticed several discrepancies or inconsistencies with their study and the OMB Circular A-21 and DoD regulations, as well as areas of concern. The first area of concern noticed was the $313 thousand disparity in the financial downloads and the financial report that could not be reconciled. While, in respect to the overall budget, this figure may seem inconsequential, it cannot safely be assumed that this figure would not have some effect on the rate determination process. Also, it should be noted that no audit was conducted on the data NPS provided. While we have every confidence in the NPS Comptroller staff, we recognize the difficulties they experienced in gathering the appropriate data from the accounting system. Considering the difficult, intricate and sensitive accounting system, coupled with no audit, leaves a reasonable amount of doubt as to the accuracy of the data provided to PwC to conduct their study.

Another area regarding the validity of data lies with how PwC designated costs to cost pools based on relative or proportional benefit to the activity. Internal surveys were conducted, but no evidence is provided into how this proportional benefit was derived. In addition to this, when cost activities could benefit both the Instruction and Research functions, they defaulted to Instruction, creating an inflated rate. Although this is subsequently addressed by the NPS Ad Hoc Faculty Committee, this fact infers that the PwC report, though thorough, may not be as accurate as desired or necessary.

The potential for inaccurate space statistics exists as no official survey has been conducted. PwC relied on a 2004 Base Realignment and Closure data call, affording us no backup documentation to trace the data origins. A true space study must be conducted to provide reasonable certainty in the F&A rates provided by PwC. False numbers based on space may allow for disproportionate cost allocation between Instruction and Research.

If following guidelines of the OMB Circular A-21, then section G13 must also be followed. Section G13 states, "At the time an F&A cost proposal is submitted to a cognizant Federal agency, each institution must describe the process it uses to ensure that Federal funds are not used to subsidize industry and foreign government funded programs." Although NPS officials do not reasonably expect that this would ever happen, the NPS has no such process established or in place to ensure that this would *not* happen. Along the same lines, OMB A-21 section K2a2 states:

> No F&A cost rate shall be binding upon the Federal Government if the most recent required proposal from the institution has not been certified. Where it is necessary to establish F&A cost rates, and the institution has not submitted a certified proposal for establishing such rates in accordance with the requirements of this section, the Federal Government shall unilaterally establish such rates. Such rates may be based upon audited historical data or such other data that have been furnished to the cognizant Federal agency and for which it can be demonstrated that all unallowable costs have been excluded. When F&A cost rates are unilaterally established by the Federal Government because of failure of the institution to submit a certified proposal for establishing such rates in accordance with this section, the rates established will be set at a level low enough to ensure that potentially unallowable costs will not be reimbursed.

The final F&A rates that NPS establishes must be fully justified and substantiated, which the PwC report does not provide. An auditable product and process must be established to support to other federal agencies the rates they are to be charged. The PwC report alone is insufficient.

Further questionable use of the OMB A-21 lies with section G8 that limits reimbursement of administrative costs to 26% of the MTDC for G&A, Departmental Administration, Sponsored Projects Administration, and Student Administration and

Services – all under “Administration”. Neither the PwC report nor the OMB A-21 provides justification or explanation for this limitation. For an institution in which reimbursable funding constitutes 59% of the university’s total budget authority, this limitation may not be applicable.

PwC conducted their study based on MTDC while NPS uses direct labor. According to the Ad Hoc Report, the NPS accounting system cannot track costs based on MTDC and therefore uses direct labor. This is also “in keeping with the spirit of the NAVCOMPT guidance of recovery against direct labor.” While we question the validity of many components of gathering the MTDC, it provides a more complete base compared to direct labor with which to derive indirect cost rates. MTDC encompasses all applicable direct and indirect costs while the direct labor base is limited to in-house and contract labor. Upon confirmation from appropriate channels, NPS plans to recover F&A rates based on MTDC versus direct labor starting in FY06, although they currently do not have the systems capability to do so.

F. CONCLUSION

While PwC conducted a thorough cost analysis, several questions remain as to its accuracy, validity, and complete applicability to NPS. Alternative cost allocation methods, such as cost-based, market-based, and benefits-based pricing models, should be explored to determine an ideal costing method applicable to DoD education institutions. DoD policies must consider the capabilities of the DoD accounting systems to properly identify and allocate costs among activities and functions and make all possible improvements to the systems in order to provide reliable, auditable financial reports. Any auditor or sponsor should be able to fully substantiate the financial data involved in F&A rates. Functions according to the OMB A-21 may be too restrictive based on the NPS accounting structure and system. Further analysis on DoD regulations is required to complete our analysis of PwC’s recommended F&A rates and the use of OMB Circular A-21.

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IV. DOD FINANCIAL MANAGEMENT POLICY

A. OVERVIEW

NPS has seen its role in the area of graduate education change significantly over the last several years. What used to be a school that primarily provided post secondary education to mostly Naval and Marine Corps officers has now evolved into a truly “purple” environment, where a significant number of students from all branches of the Department of Defense, numerous federal agencies, and military officers from allied nations receive advanced education. The school’s research mission has also weathered an overhaul of sorts. Research dollars flowing into the school now exceed the amount of appropriated funds NPS receives from Naval Education Training Command (NETC) for the operations and maintenance of the school and its facilities.

After thorough examination of PwC’s final report, several questions developed. Why did PwC use OMB Circular A-21 as its guiding regulation? Is this the correct regulation for this particular scenario? How does the firm’s recommendations relate to what is outlined in the DoDFMRs? Is there any precedence that supports or prohibits implementing their recommendations?

The purpose of this chapter is to shed light on these questions through a detailed review of government regulations that goes beyond OMB A-21. First, OMB A-21 is examined for its content in order to answer why it was used as the basis for the PwC study. Whether or not it was and is the correct guidance to use is concluded. The DoDFMRs are reviewed, specifically as they relate to reimbursements for indirect costs. Then, regulations governing interagency support agreements are examined. Are indirect costs reimbursable? Finally, an exploration of U.S. Comptroller General decisions that deal specifically with interagency support and indirect costs is required.

B. OMB CIRCULAR A-21

The OMB Circular A-21, “Cost Principles for Education Institutions”, was established to provide a guide for educational institutions in determining reimbursement

rates for government sponsored research. The intention was to provide a standard set of principles that all educational institutions could use to deal with cost determination applicable to all government sponsored contracts, grants, and other agreements. Basically, the guidance was provided to ensure that the government bears its "fair" share of research related costs. The regulation applies to "all Federal agencies that sponsor research and development, training, and other work at educational institutions…." Additionally, "Federally Funded Research and Development Centers associated with educational institutions shall be required to comply with the Cost Accounting Standards, rules and regulations issued by the Cost Accounting Standards Board, and set forth in 48 CFP part 99; provided they are subject thereto under defense related contracts."

Based on their vast experience with civilian research universities, PwC did a complete and thorough job of adhering to the guidelines set forth in the OMB A-21. Their method of data collection, development of cost pools, inclusion and exclusion of certain cost elements, and the final recommendation of rates as determined using the guidance outlined in the OMB A-21 goes uncontested. Based on an analysis of the OMB A-21, their final report is consistent with the provisions outlined.

Our contention is that the provisions of the OMB Circular A-21 do not apply to NPS and, therefore, should not have been used as the guidance governing this study. While we concede that NPS is in fact a university, it falls under the umbrella of the federal government, and must be considered as "federal" first and a university second. We assert that the OMB A-21 does not apply for the following four reasons:

1. OMB Circular A-21 was intended for civilian colleges and universities
2. NPS is bound by Project Order Law and the Economy Act
3. DoD Instruction 4000.19 governs intragovernmental support
4. Capturing indirect costs under OMB A-21 not possible

Each of these reasons will be discussed in the following sections.

1. OMB Circular A-21 was Intended for Civilian Colleges and Universities

While it seems logical to use this guidance because NPS is an educational institution, a closer read reveals that the guidance's intent is for use between research-oriented civilian universities and the federal government. Under *Purpose and Scope*, the regulation reads:

> Objectives. This Attachment provides principles for determining the costs applicable to research and development, training, and other sponsored work performed by colleges and universities under grants, contracts, and other agreements with the Federal Government. These agreements are referred to as sponsored agreements.

The OMB A-21 further clarifies by defining sponsored agreements as "any grant, contract, or other agreement between the institution and the Federal Government." The regulation is clearly referring to agreements between the federal government and a non-federal government entity. NPS is technically an entity of the federal government and funded with appropriated dollars as such. Therefore, we conclude that the OMB A-21 is not applicable to cost recovery at NPS. Employees of NPS who perform reimbursable research are federal employees covered by different rules and regulations than their civilian counterparts.

2. NPS is Bound by Project Order Law and the Economy Act

Project Order Law, Title 41, United States Code, section 23, and the Economy Act (31 U.S.C. 1535) provide legal authority for one entity of the U.S. Government to provide goods or services to another. This statutory guidance also outlines policies and procedures in relation to interagency acquisitions. Subpart 17.501 defines interagency acquisition as "a procedure by which an agency needing supplies or services (the requesting agency) obtains them from another agency (the servicing agency)." The Economy Act authorizes agencies of the federal government to enter into mutual agreements to provide goods or services when it is deemed in the best interest of the Government. Since NPS is an arm of the federal government, in terms of reimbursable programs, the school would be considered the servicing agency. Therefore, all

agreements between NPS and other federal agencies are bound by the provisions of these acts, codified in U.S. law, which supersedes the OMB guidance.

3. DoD Instruction 4000.19 Governs Interservice and Intragovernmental Support

The above mentioned regulation imparts guidance for providing service and support within the Department of Defense and is rooted in the provisions of Project Order Law and the Economy Act. Since NPS is a subordinate entity of NETC, it obviously qualifies to be termed a DoD entity. The DoD financial management regulation relating to support agreements adheres to the standards of DoDI 4000.19 and provides clear policies and procedures on how to treat interagency support agreements.

4. Capturing Indirect Costs Under OMB-A21 Not Possible

OMB A-21 allows for collection of a portion of indirect costs (referred to as Facilities and Administration or F&A) in relation to service provided on federally funded programs. These provisions were included as a way for civilian institutions to recoup a reasonable portion of costs incurred, but not directly attributable to any particular program or project. Under the F&A section of OMB A-21, allowances for depreciation, space costs, interest on debt, and operations and maintenance expenses are included. Since NPS is a federally funded DoD entity, depreciation and interest are not applicable, and collection of indirect operation and maintenance expenses would be considered an augmentation of appropriations and violation of appropriation and fiscal law.

Other questions surfaced in analyzing OMB A-21. Given that the regulation was intended to govern transactions between the government and civilian entities, and that NPS is federally funded, what appropriation and fiscal law implications, if any, would result? The regulation also stipulates that adequate documentation must support reimbursable costs. Can the school meet this requirement? While these questions certainly warrant further exploration, the scope of this project prevented further analysis.

After a thorough analysis of the study and guidance used to develop it, we conclude that OMB A-21 was the wrong regulation to apply in this scenario. OMB A-21 clearly was intended to apply to civilian colleges and universities, not to government-to-government transactions. Given that guidance already existed for intergovernmental transactions, as well as DoD regulations, applying the provisions of OMB A-21 puts NPS in a position of 1) not following DoD guidance and 2) in violation of the statutory provisions of Project Order Law and the Economy Act.

C. DOD FINANCIAL MANAGEMENT POLICY

Department of Defense Financial Management Regulation DoDFMR 7000.14 was drafted to establish clear, concise, and standardized financial management policies and procedures. In addition to policies and procedures, the regulation also sets standards of performance, business principles, and enforcement of these standards. The overarching goal of the regulation is to provide the DoD with a guide of how to conduct operations within the parameters of regulatory and statutory requirements established by our civilian leaders. Financial management regulations within the military services of the department are subordinate to the DoDFMRs.

1. Allowable Reimbursable Costs

The DoDFMRs provide clear guidance as to the procedures for collecting reimbursements, supporting documentation requirements, and what costs are actually reimbursable. Volume 11A, Chapter One specifies that all direct costs relating to civilian labor, military labor (only for DoD Working Capital Fund accounts), temporary duty (TDY) costs, property/inventory expenses, contracts, accessorial expenses, asset use costs, and repair and maintenance are reimbursable. The provisions from this chapter are derived from DoD Instruction 4000.19, *Interservice and Intragovernmental Support*, which outlines policies, procedures, and responsibilities for interservice and intragovernmental support agreements. This regulation serves as the basis for guidelines outlined in the DoDFMR

In order for a performing agency to obtain reimbursement, a formal agreement must be in place prior to performance of work or service. A memorandum of understanding (MOU), memorandum of agreement (MOA), or a universal order are the principle documents by which agencies agree to the nature of support that is to be provided, an estimation of costs that are to be reimbursed for such support, and method by which reimbursement is to be collected. Figure 5 provides a detailed listing of the different information that any support agreement should include.

Figure 5. Minimum Essential Information for Support Agreements

1. The authority for entering into the MOU or MOA, such as "Economy Act (31 U.S.C 1535 or the "Project Order Law" (41 U.S.C. 23).
2. A description of the material or services required.
3. The established dollar limits and any authority to exceed applicable limits with specific approval from the ordering activity.
4. The financing source or fund citation.
5. The delivery requirements.
6. The payment provisions.
7. The duration of the agreement.
8. The form in which specific orders against the MOU or MOA will be placed, for example, telephone calls, memoranda or supplementary formal orders.

In addition to providing clear guidance on policies, procedures and the nature of reimbursable costs, the DoDFMRs also dedicate a section to the discussion of overhead and associated costs. Section J of Volume 11A, Chapter One defines overhead as "indirect or general and administrative costs, which consist of costs that cannot readily,

or directly, be identified in the performance of a customer order. Examples of such costs are supervision, office supplies, utility costs, etc."

Paragraph two of the section stipulates that overhead charges are *not normally* considered reimbursable, and therefore should not be included for reimbursement in intra-agency agreements. The logic behind this principle is simple. Each year Congress appropriates dollars to the various federal agencies for the coming fiscal year. Agencies are expected to execute their respective missions, and do so within the confines of the budget Congress passed. Appropriation law is very clear about augmenting budgets passed by Congress – it is illegal! The Anti-Deficiency Act, Necessary Expense Rule, and Bona Fide Need Rule are all examples of limitations in place to ensure agencies live within established budgetary and fiscal constraints, and spend taxpayer dollars wisely and for legitimate purposes. Collection of indirect costs could be construed as a violation of these limitations. As previously mentioned, each agency receives an annual budget and is expected to operate within that budget. The budget is intended to fund *all* of the agency's operations for the year. General and administrative expenses are part of this budget, and in theory, already funded for the year. Collection of these general and administrative expenses through the reimbursement process could give the impression that the agency is augmenting its budget authority and circumventing Congressional appropriators.

Despite the provision that states overhead costs are not normally reimbursable, the regulation does allow for exceptions:

> If an organization has a significant amount of reimbursable effort, such costs are accumulated in a cost pool and allocated to customers. In the absence of a cost accounting system, applicable costs may be estimated.

While the regulation clearly stipulates that overhead costs are not normally reimbursable, it stops short of prohibiting the practice. In instances where reimbursable efforts constitute a significant amount of funds, collection of overhead is acceptable. The ambiguous nature of the regulation leaves a wide gap for interpretation. What constitutes a significant reimbursable effort? What methods are appropriate for estimation? What about supporting documentation requirements?

D. COMPTROLLER GENERAL DECISIONS

To help clarify the ambiguity found in the DoDFMRs, we conducted a thorough review of U.S. Comptroller General decisions to determine if precedence existed regarding the recouping of indirect costs. Expectation was that this was not the first time the issue had surfaced. We found three decisions germane to this issue:

1. Decision of the Comptroller General B-195347 (1980)

The Merit Systems Protection Board (MSPB), established by Reorganization Plan No. 2 of 1978 and codified under the Civil Service Reform act of 1978, was created to serve as the quasi-judicial arm of the executive branch concerning the civil service and the federal merit system. Under the law establishing the MSPB, they are responsible for conducting hearings when an employee files a complaint or appeal of an agency personnel action. After budget cuts significantly reduced funding available for travel expenses related to such hearings, the board of the MSPB determined that if hearings were to be conducted at the location of the grievance, the federal agency involved must provide funding to cover the hearing officer's travel expenses. If funds were not provided, the hearing would be conducted in MSPB offices.

The Comptroller General ruled that this practice was not authorized because reimbursement would in essence augment appropriated funds that the MPSB already receives. The decision explains that reimbursement is authorized under the Economy Act when no other laws permit transfer of appropriated funds. However, under Reorganization Plan No. 2, the board is required to provide officers for such hearings. The decision went on to explain that providing necessary travel expenses was the responsibility of the MPSB, and reimbursement of these expenses was, in fact, an augmentation of the agency's funds and a violation of appropriation law.

This decision is relevant to NPS because it raises the question of augmentation of appropriated funds. Since NPS receives funding from the Navy, it could be argued that

the school already receives funding to cover indirect costs. Any effort to collect reimbursements for such costs would augment funds already received and violate appropriation law.

2. Decision of the Comptroller General B-198531 (1980)

In this case, Isotec Incorporated challenged the Department of Energy and its practices regarding the sale of isotopes to other federal agencies. The complaint centers around Energy's practice of excluding indirect costs as part of the total cost that other agencies pay for isotopes, while such costs are included in sales to commercial entities. Isotec's claim insinuates that Energy's practice of excluding indirect costs (i.e. depreciation and interest) is anti-competitive towards commercial business and is ultimately a form of price discrimination that undervalues the true cost of producing isotopes. In the end, the Comptroller General determined that Energy's practice was acceptable and proper under the provisions of the Economy Act.

The additional comments made in the decision are more revealing than the decision itself and strike at the heart of the issue at hand for NPS. The Comptroller General discusses at length the notion of collecting indirect costs. The term "actual cost" is introduced here. While the law and legislative history are silent as to what is meant by actual cost, it is reasonable to assume that actual costs obviously included direct costs, but could also include indirect costs, which ultimately factor into capturing the full cost of providing service or support. The decision recognizes that indirect costs funded with appropriated dollars, while not directly attributable to a particular service or support activity provided, are relevant in determining actual cost of providing the service. If a significant relationship exists between indirect costs and the support provided, those indirect costs are recoverable under the provisions of the Economy Act. The decision goes on to state that for an agency to collect reimbursement for indirect costs it must be able to show benefit to the supported agency and the cost would not otherwise have been incurred if support was not provided.

3. Decision of the Comptroller General B-257823 (1998)

The Federal Mediation and Conciliation Service (FMCS) brought a complaint against the Financial Management Service (FMS) for including indirect costs as part of its standard rate for reimbursement of service provided. FMS developed indirect cost rates for employees based on historical data. Factors included in the development of these indirect rates are average time an employee spends on administrative tasks, actual levels of work performed, lead time between customers, and estimates of anticipated workload growth. All customers were charged for employee time directly attributable to service performed, as well as indirect costs associated with support using the indirect cost rates mentioned earlier. FMCS argued the indirect rates overestimated the time employees spent performing administrative tasks. The Comptroller General found the actions of the FMS to be reasonable and methods used to develop rates were consistent with the provisions of the Economy Act.

There are three important concepts to learn from this decision. First, it supports the notion that collection of indirect costs is appropriate and sometimes necessary. The entire decision is based on recognition of indirect cost as part of the actual cost of providing service. Even the complaint itself brought by FMCS does not challenge the collection of indirect costs, but rather the method for determining indirect reimbursable rates.

Second, this decision supports the estimation of indirect rates in the absence of concrete accounting data. Rate estimation is necessary because the FMS lacked an accounting system that provided verifiable data as to what was being spent on indirect cost. FMS knew it was incurring indirect costs in support of its customers, but lacked the ability to capture that data and develop rates.

Finally, in the absence of an accounting system to provide this kind of data, this decision supports developing rates through estimation, using reasonable logic and analysis. FMS examined several activities and had good data to support employee time spent on these activities. From this data, they developed fair rates that provided a

reasonable estimation of what these activities cost them. Then, they applied the indirect cost to all customers based on service provided.

This decision supports the movement within NPS for indirect cost reimbursement. If the reimbursable research program didn't exist, NPS would not incur many of these indirect costs, therefore, recovering these costs is warranted. Absent a detailed accounting system, the PwC analysis provides a reasonable estimation of what rates should be charged and how they should be applied to program sponsors.

E. CONCLUSION

PwC conducted an extremely thorough analysis of NPS costs and followed the guidance set forth in OMB Circular A-21. We do not contest their findings under the provisions of this regulation. However, we do question why OMB A-21 was used in the first place. While on the surface it might seem logical that this was the appropriate guidance to use given that NPS is an academic institution, a thorough read leads us to believe the PwC study incorrectly applied this regulation in their study. OMB A-21 was intended to govern business between civilian academic institutions and the federal government. Since NPS is an arm in the federal government, applying OMB A-21 is inappropriate. Since NPS is a funded entity of the government, statutory regulations are in place that govern business transactions between NPS and entities of the federal government. OMB A-21 is silent on the provisions of Project Order Law and the Economy Act because it deals only with civilian universities. Finally, applying the provisions of OMB A-21 does not make sense. Provisions for capturing depreciation and interest on debt are not applicable to federal agencies and charging for indirect operations and maintenance expenses would result in a violation of appropriation and fiscal law.

After establishing that OMB A-21 was the wrong guidance to use, we analyzed the correct references for PwC to use to guide their study. DoDFMRs provide a somewhat clearer picture of how interagency transactions are to be conducted. Written agreements between agencies, called Support Agreements, provide each agency the authority to enter into such an agreement, a clear description and nature of support to be

performed, terms for what is reimbursable and procedures for collection of such reimbursements. The DoDFMRs also provide an idea, though not very clear, of what can be considered reimbursable. While collection of reimbursement of direct costs is clearly acceptable, collecting indirect costs is not so crystal clear. The regulations stipulate that indirect costs are not normally reimbursable; however, it stops short of prohibiting collection. In fact, in cases where the reimbursable effort is significant, overhead (i.e. indirect) can be collected into cost pools and allocated to customers.

To further clarify, we turned to decisions of the Comptroller General for assistance. We found three cases we felt were relevant to this topic. In the first case, it was decided an agency can be reimbursed for duties that legislative guidance directs it to perform. In this scenario, the agency would in effect be collecting reimbursements for which it theoretically receives funding from appropriations, clearly a violation of appropriation law.

10 U.S.C. Chapter 605 establishes the Naval Postgraduate School for the advanced instruction of naval officers, and allows officers from other military services to attend on a reimbursement basis. No provisions are made for reimbursable programs conducted at the school. Therefore, under this decision, we conclude that NPS is not in violation of appropriation law by collecting reimbursement for indirect costs.

The final two Comptroller General decisions we examined provide a sense of legitimacy to the practice of indirect cost reimbursement. Decision B198531 introduces the notion of “actual cost” and asserts that costs not directly attributable to a particular customer or project are recoverable if the performing activity can demonstrate the costs to be reasonable, provide benefit to the supported agency, and would have otherwise not be incurred if support had not taken place. Decision B257823 further supports collection of indirect costs, even in the absence of detailed cost accounting records, provided that estimation of associated costs are determined in a logical manner and deemed to be a fair estimation of what providing support indirectly cost the performing agency.

V. SUMMARY/CONCLUSIONS/RECOMMENDATIONS

The sustained growth of the reimbursable research and education programs at NPS over the past several years have forced administrators to rethink how they charge sponsors of reimbursable activities for indirect costs and question whether current reimbursement rates accurately capture the actual cost of providing reimbursable activities. To help answer these questions PwC was hired to assess the school's current cost structure and recommend adjustments to the rates charged to sponsors. One of the major questions that ascended from PwC's recommendations was the issue of charging sponsors for indirect costs incurred. We, too, questioned the validity of recouping indirect costs. As professional DoD financial managers, we understand that the subject of indirect cost collection is not part of normal day-to-day operations. After a thorough review of the DoDFMRs, we were unsatisfied with the clarity of the guidance in this situation. After an exhaustive search of U.S. appropriation law, DoD guidance governing intra-agency support, and previous U.S. Comptroller General Decisions, we gave merit to the arguments raised in support of indirect cost collection.

So what is next? It is not enough to claim the DoDFMRs are ambiguous or do not govern every circumstance or situation. If the school was audited, an auditor is unlikely to take the time to research appropriation law or Comptroller General Decisions to determine if the school's position is supported. NPS must take the lead role in supporting, defending, and justifying its actions if it is going to proceed with indirect cost collection.

Below are several recommendations for the school if it is going to proceed with indirect cost collection. As this process evolves, school administrators will need to make continuous adjustments to ensure that rates accurately reflect costs incurred and that collections do not augment any appropriated funds received.

A. CLARIFY FACULTY AD HOC COMMITTEE REPORT

Overall, the Ad Hoc Committee accomplished a noble report on indirect costs dated 15 June 2004. They provided extensive background and history on indirect costs for reimbursable projects at the Naval Postgraduate School. They also explain their concerns with the study performed by PricewaterhouseCoopers, as detailed in Chapter II. On the other hand, they fell short in fully describing the methods used to determine the proposed indirect costs rates.

In the Ad Hoc Faculty Committee report, they explain some methodology used for determining indirect costs rates. They acknowledge the use of PwC study as a guidance and framework for identifying the different costs categories and actual costs within these categories. The committee also made adjustments to the PwC rates based on consideration of several factors. These factors are illustrated in detail in the report and also in Chapter II of this study. Finally, they provided a table that shows the recommended rates by Ad Hoc Committee against the recommended rates by PwC.

However, one thing not shown or explained is exactly why these rates differ. The report does not explain, for example, why the proposed sponsored research (DoD) for On-Campus rate is 30.59% according to the committee and 41.01% according to PwC. It is imperative to the rates' validity to show and explain in detail why their rates differ from PwC's. This will also provide a better understanding of what is included in each of the rates.

B. MAINTAIN METICULOUS RECORDS

In order to be able to track and recoup all applicable indirect costs, a good accounting system is needed. This system should be able to offer the capacity of inputting and coding transactions of each of the different departments and units at NPS. This is essential in order to ensure that all costs are effectively and efficiently assigned and charged to the proper organization. With a sound accounting system in place, there would be no question whether NPS is fully recovering all reimbursable costs due them and ensuring no sponsor is over or undercharged.

Maintaining an accurate set of accounting records also serves another purpose -- defense of the school during a formal audit. The major problem with indirect cost collection is the appearance of appropriated funds augmentation. An aggressive approach by the school to maintain detailed, meticulous accounting records will help ensure appropriated funds are not augmented through this collection process. Detailed records will not only help the school in determining appropriate rates, but they will also send a signal to auditors that the school is doing everything in its power to ensure an accurate rate structure that does not circumvent the appropriations process.

C. ANNUAL AUDIT OF INDIRECT COST COLLECTION

In addition to maintaining detailed accounting records, we recommend the school conduct an annual in-house audit of the indirect cost collection process. An in-house audit will force the school to continually review the reimbursement process and identify problem areas. It will also help ensure reimbursements collected are going to the right activities and not augmenting appropriated funds.

If audits are conducted in house, they should be conducted by personnel outside the reimbursement process, for example, someone outside the Comptroller or Reimbursable Program Office. Once the audit is complete, a final report of findings should be made to the Ad Hoc Committee.

D. RECEIVE CONCURRENCE OF THE DOD COMPTROLLER

The school could be inviting trouble by proceeding with collection of indirect costs without concurrence of the DoD Comptroller. Before the school proceeds with collecting reimbursement for indirect costs incurred, we recommend they solicit for and receive written concurrence from the DoD Comptroller.

In Chapter IV we conducted a thorough review of DoD regulations that govern the financial management practices of agencies within the Department. The DoDFMRs were drafted and implemented with the intent of providing clear, concise guidance, policy, and procedure on how to conduct financial management operations within the

Department. However, our analysis concluded that the guidance was ambiguous in nature and left too much open for alternative interpretation. Prior to implementation of the DoDFMRs, each military service had their own regulations that set financial management policy and procedure. The Navy version was the Navy Comptroller Manual (NAVCOMPT). Within the language of this manual, NPS was granted an exception to the standard rule that prohibits reimbursement of indirect costs:

> The Naval Postgraduate School, Monterey, CA, is exempt from this policy and is authorized to recover indirect costs incurred that are significantly related to reimbursable research projects by means of applying an indirect cost rate based upon the direct labor cost. The total amount of these indirect costs applicable to each project will be stated in the budget page of each bid and proposed together with a brief explanation statement. The recovery of significant costs will be in accordance with Par. 075120-3, which requires such costs to be additional, identifiable, and segregated on a reasonable and meaningful basis. The Naval Postgraduate School is required to follow the procedures authorized by the Comptroller o the Navy for allocating indirect costs to reimbursable research projects.

When the new DoDFMRs were issued, NPS sent a letter to the Principal Deputy Assistant Secretary of the Navy (Financial Management and Comptroller), (see Appendix A), requesting that an exception be granted to allow NPS to continue collection for indirect costs. After nearly a year with no response, the school sent a second letter (see Appendix A) again making the request for the exception and stating the school will proceed with indirect cost collection unless otherwise directed. While we understand the school's position, desire for clarification, and need for resolution, the school's effort must not stop with this second letter. Even though the school's position is supported by the two Comptroller General Decisions mentioned in Chapter IV, the support and approval of the Comptroller for the Department of the Defense would further legitimize the school's practices. Approval would answer many of the questions still surrounding collection of indirect costs, signal to administrators and customers that the practice is appropriate and authorized, and diminish any appearance that the school is augmenting appropriated funds through its reimbursable research program.

E. LOBBY TO HAVE THE DODFMRS CHANGED

One of the major advantages that our military has over others is the degree to which we train and educate our military members. Over the past several years, we have seen an increase in the number of educational institutions and programs within the Department of Defense. Why not create separate and specific guidance within the DoDFMRs to cover these institutions and programs? We assume NPS is not the first educational institution within the DoD to experience this dilemma. The Air Force Institute of Technology (AFIT), military service academies, and service professional military education (PME) institutions probably all faced similar dilemmas at some point or another. By creating separate guidance, policy and procedures can be tailored to provide an adequate amount of instruction while still meeting the unique mission requirements of these institutions. Furthermore, specific guidance would provide a standard for all educational institutions to follow and could help the DoD more accurately capture the cost of service performed.

Prior to collection of indirect costs, NPS absorbed all indirect support expenses within its appropriated fund baseline. There are two problems with this method. First, it is inaccurate; it does not capture the true cost of providing the support or service to the requesting agency. Secondly, absorption of indirect costs results in NPS subsidizing a portion of the actual cost of providing the support. As budgets become tighter and cuts become a reality, the research would invariably suffer. Dedicating a portion of the DoDFMR to educational institutions would clarify gray areas and allow institutions like NPS to perform reimbursable programs without having to worry about where the dollars are going to come from to pay for indirect costs.

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APPENDIX: REPORT OF THE FACULTY AD HOC COMMITTEE ON INDIRECT COSTS

REPORT

of the

FACULTY AD HOC COMMITTEE

on

INDIRECT COSTS

Professor Kenneth Davidson, Chair
Graduate School of Engineering and Applied Science

Professor Joe San Miguel
Associate Professor Doug Moses
Graduate School of Business and Public Policy

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School of International Graduate Studies

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Professor Michael Zyda, Institute Representative
Modeling, Virtual Environments, and Simulation Institute

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Graduate School of Engineering and Applied Sciences

Advisors:
Danielle Kuska
Director, Research and Sponsored Programs Office

Leonard Ferrari
Associate Provost and Dean of Research

Julie Filizetti
Associate Provost for Academic Affairs

15 June 2004

EXECUTIVE SUMMARY

Indirect (Facilities and Administrative) expenditures are a real cost associated with Sponsored Programs at a University. The Naval Postgraduate School has recovered indirect costs under the authority contained within the NAVCOMPT Manual. With the rescission of the individual service manuals, it was necessary to review the indirect cost policies and processes at NPS. A Faculty Ad Hoc Committee (Appendix A) was appointed by the Provost to work with three principal advisors, Dean of Research, Associate Provost for Academic Affairs, and the Director of the Research and Sponsored Programs Office, to oversee this process. PricewaterhouseCoopers (PwC) was contracted to provide an initial facilities and administrative proposal based on the guidance contained in OMB Circular A-21.

The Committee's recommendations summarized below and detailed within this report assume the following: a)The effective indirect cost recovery on sponsored programs will not negatively impact mission funding provided to departments/schools/institutes or other support functions receiving indirect cost recovery, and b) that strong consideration will be given to fully funding the contractual (9-month) period for tenure and tenure-track faculty. It is assumed that the faculty workload relief funding will contribute to this contractual obligation.

There are particular identifiable aspects of the PwC study that argue against a direct extrapolation of the study's findings. This fact, coupled with the uniqueness of the NPS university environment and an analysis of causal/beneficial relationships, has produced the following recommendation for FY05/FY06 indirect cost rates:

COMMITTTEE RECOMMENDED INDIRECT RATES (%)			
Activity	**Sponsor**	**On-Campus**	**Off-Campus**
Research	Navy	21.59	19.43
	DoD	30.59	19.43
	Non-DoD	30.90	19.78
Instruction	Navy	19.23	19.23
	DoD	26.03	19.23
	Non-DoD	29.29	20.82
Other Sponsored Activities	Navy	16.82	16.82
	DoD	26.67	17.63
	Non-DoD	26.67	17.63

The Committee proposes a distribution of indirect recovery that acknowledges and provides for reimbursement or re-investment across the range of the university's resources (physical, information, organizational and programmatic). Certain conditions have been recommended for reinvestment, i.e., a set percentage that will be distributed by the indirect cost recovery recipient with input from a faculty advisory council.

INDIRECT COSTCOMMITTEE RECOMMENDED DISTRIBUTION					
RECIPIENT			DISTRIBUTION PERCENTAGE		
Associated Individual	Associated PwC Cost Pools	Organiza-tional Level	Instruction Indirect Distribution % of total	Research Indirect Distribution % of total	Other Sponsored Indirect Distribution % of total
Provost	Facilities: O&M + Lib	University	15	10	10
Provost	General Admin		12	10	10
Assoc Provost -Academics	Academic Admin		20	-	-
Dean-Research	Research		-	15	15
Sponsored Programs Ofc	Spon Program Admin		2	8	8
School Deans	N/A	School	5	3	3
Depts/Inst	Dept. Admin	Dept / Inst	41	34	34
PIs/PMs	Instruction/ Research	Program	5	20	20

Details for the rationale for the above rates and distribution allocation are included herein as well as recommendations for policy and administration. The Committee fully understands the complexity and inter-connectivity between sponsored programs and associated indirect recovery and the mission budget of NPS. To this end, collateral recommendations are respectfully submitted within this report.

1. **BACKGROUND:**

The Naval Postgraduate School was granted authority to recover indirect costs by the Navy Comptroller. An "exception" was inserted into the NAVCOMPT Manual allowing the recovery of those costs that:

> "The Naval Postgraduate School, Monterey, CA, is exempt from this policy and is authorized to recover indirect costs incurred that are significantly related to reimbursable research projects by means of applying an indirect cost rate based upon the direct labor cost. The total amount of these indirect costs applicable to each project will be stated in the budget page of each bid and proposed together with a brief explanation statement. The recovery of significant costs will be in accordance with Par. 075120-3, which requires such costs to be additional, identifiable, and segregated on a reasonable and meaningful basis. The Naval Postgraduate School is required to follow the procedures authorized by the Comptroller of the Navy for allocating indirect costs to reimbursable research projects. "

NPS has continued to recover indirect on reimbursable research at the rate established in 1995. In 2002, it was announced that the Federal Management Regulation (FMR) superseded the NAVCOMPT Manual. The services were requested to provide input to special circumstances/situations specific to their service that should be considered for an addendum to the FMR.

In July 2002, the Comptroller (Megan Reilly) and Director, Research and Sponsored Programs Office (Danielle Kuska) met with OASN (FM&C)(Lou Calabro (FMB-51)). The NPS exception included in the NAVCOMPT Manual was discussed and verbal approval was received to continue the recovery of indirect costs against reimbursable programs.

The Superintendent (RADM David Ellison, USN) sent a letter (Appendix B) to FMB Policy in July 2002 to follow-up with the formal request for the inclusion of specific language in the FMR to except NPS to continue indirect cost recovery on sponsored programs. The letter specifically included language specifying indirect cost recovery against reimbursable research and education. It was further declared that NPS would follow the guidance of OMB Circular A-21 as much as possible.

A second letter (Appendix B) was sent by the Superintendent restating the initial request. This second letter stated that NPS would continue with the recovery of indirect costs against reimbursable research and proceed with the recovery of indirect costs against reimbursable education unless instructed to do otherwise.

In July 2003, a solicitation was issued to assist NPS in the establishment of the facilities and administration (indirect cost) rate for sponsored programs. PricewaterhouseCoopers (PwC) was awarded the contract in September 2003.

The Provost established the Faculty Ad Hoc Committee on Indirect Costs to oversee the process for the establishment of the Indirect Cost Rate and recommendation of associated policies. The Committee recommended the establishment of interim rates pending the completion of the study by PwC. The indirect cost rates effective 1 October 2003 were:

Research:	Instruction:
On Campus: 23%	On Campus: 17%
Off Campus: 13.75%	Off Campus: 6%

The PwC Study was completed on 31 March 2004. The results of the study were briefed to the Committee, Research Board, Deans and Chairs, and the Provost and Superintendent. An open forum meeting was also held for all faculty. A copy of the study is available.

2. DISCUSSION:

Committee members were provided a copy of the PwC report. Weekly meetings were scheduled to review the PwC report. Committee members were asked to provide an alternate representative. Designated members or alternates were expected to attend each meeting.

Concerns: Specific concerns addressed by Committee Members included:

Legality of Recovery: The FMR states that DoD will not collect indirect from other DoD entities (DoD FMR, Volume llA, Chapter 1, General Reimbursement Procedures and Supporting Documentation.)

Validity of Guidance: OMB Circular A-21 governs the cost-principles for universities that have received federal contracts and awards for fully reimbursable services. NPS, as a DoD entity is not subject to the OMB Circulars and does not receive similar awards requiring full cost payments by the federal government.

Basis of Study: OMB Circular A-21 reviews expenditures from the previous year and allocates expenditures to cost pools. There are other means of determining overhead, i.e., using a cost-based, market-based, or benefits-based pricing model.

Validity of Data: Question of oversight in designation of costs to cost pools.

Competitiveness: Increased costs for sponsored programs may present problems with funding agencies, and they may seek alternative, non-NPS providers.

Complexity of Rates: The PwC Study recommended a Navy, DoD, and non-DoD rate in each of the categories (Research, Instruction, and Other Sponsored Activities) with an on and off-campus component in each.

Modified Total Direct Costs: OMB Circular A-21 calls for recovery against Modified Total Direct Costs if an Institution's sponsored program exceeds $10M annually. This represents a significantly higher base for recovery than total direct labor, as is the current base.

Overall Increase in Rates: All rates computed in the PwC Study are considerably higher than those currently levied on reimbursable programs. Serious concern, especially for the high reimbursable instruction rates, was expressed.

Resolution of Concerns: The above concerns were discussed at length. The questions of legality were corroborated by the appropriate actions by NPS to add the requisite language to the FMR. The use of OMB Circular A-21 was discussed with FMB policy and the Office of Naval Research. As A-21 is the circular written by the federal government to outline the process for establishing F&A (facilities and administration) rates in universities, it was selected as the appropriate guidance. The complexity of the rate structure has been discussed with ONR and the NPS Comptroller. ONR advised that the Navy rate should be different than that of the other DoD activities and non-DoD activities. The collection of data by PwC was overseen by the Director of the Research and Sponsored Programs Office (RSPO) and the support of the Comptroller's Office.

The argument for competitiveness was taken into consideration in the Committee's recommendation, as well as the marked increase from the current rate structure. It is also realized that the current accounting system structure will not allow for recovery of MTDC in FY05. Therefore, recovery will be limited to labor (in house and contract) in FY05. This is in keeping with the spirit of the NAVCOMPT guidance of recovery against direct labor. Recovery against MTDC is expected to begin in FY06 when confirmation is received to proceed from the appropriate channels.

3. <u>RECOMMENDATIONS:</u>

The committee's recommendations include: FY05 and FY06 Facilities and Administration rates; FY05 and FY06 distribution of recovery; and recommended policy for implementation. The committee is recommending rates associated with incremental costs resulting from reimbursable activities. The indirect recovery will be collected against labor costs (faculty, staff and contract) with the proposed rates for two years until 1) a review of the proposed indirect recovery and distribution is made by a faculty committee, 2) an appropriate space survey of facility use is completed, 3) an accounting system for recording MTDC is in place.

It is understood that Facilities and Administrative costs will be treated fairly and equitably and that the transparency of recovery and distribution will continue to be available. The criteria for waivers must be clearly defined and uniformly granted.

3.1 Proposed Indirect Rates:

3.1.1 Methodology for Determining Indirect Rates:

The Committee recognizes that indirect costs for facilities and administration are real costs associated with the conduct of both sponsored and mission programs at a university. The Committee recognizes the PwC study to be an application of a standard (A21) full-allocation methodology to NPS' Facilities and Administrative costs. The committee accepts the PwC study as a fair execution of this allocation methodology.

The committee's Charge, and approach, was to use the PwC study as the foundation for an analysis directed toward the establishment of indirect rates applicable to NPS' particular circumstances. The committee heavily relied on the findings of the PwC study as:

- A framework for identifying and understanding NPS' F&A categories and subcategories, and actual costs within categories.
- An initial benchmark for the specific indirect rates appropriate for the classes of reimbursable activities at NPS.

The committee made adjustments to the PwC rates based on consideration of three sets of factors:

1. Aspects of the PwC study: There are particular identifiable aspects of the PwC study that argue against a direct extrapolation of the study's findings.

   - Bias in floor space allocation: A lack of specificity in the NPS space records caused a disproportionate allocation of costs to instruction versus research.
   - Discontinuity: Regionalization in September 2003 occurred after the compilation of data to calculate the rates in the PwC study.
   - Absence of data: Data does not exist at NPS for two major facilities costs items that are part of the A21 model (depreciation and interest), making direct comparison of PwC findings to other universities suspect.
   - PwC stated that the General Admin and Operation and Maintenance component of NPS' rates were slightly higher than the average university.

2. Uniqueness of NPS: As an appropriations funded university, with military faculty and personnel and funded students, unique circumstances exist at NPS.
   - NPS' environment is not typical of a standard university; sponsor requirements for education are central to programs
   - NPS' faculty are not completely compensated by NPS for the pursuit of scholarly activity, i.e. research. Workload relief is not uniformly applied. All faculty labor is specifically charged to the function performed.
   - The small need for graduate student funding yields proposals primarily requesting faculty labor costs

3. Causal and Beneficial Relationships: The Committee reviewed regulations relevant to indirect costs (NAVCOMPT Regulations, Cost Accounting Standards (CAS)). NAVCOMPT regulations specify that indirect costs be "additional," meaning that the activity being charged indirect cost should have resulted in an increase in the total amount of indirect cost. CAS require that indirect cost charges be based on "causal and beneficial" relationships between activities and indirect costs, meaning that an activity ought to have caused an indirect cost to have occurred or benefited from the incurrence of an indirect cost in order to be charged. The Committee examined the detailed categorization of indirect costs provided within the PwC report and adjusted some PwC rates where an absence of causal or beneficial relationships were apparent.

3.1.2 Proposed Facilities and Administration Rates (FY05-FY06):

Using the PwC study as a guide, the Committee recommends a modification to the rates as reported. The following rates are proposed by the Committee:

COMMITTTEE RECOMMENDED INDIRECT RATES (%)			
Activity	**Sponsor**	**On-Campus**	**Off-Campus**
Research	Navy	21.59	19.43
	DoD	30.59	19.43
	Non-DoD	30.90	19.78
Instruction	Navy	19.23	19.23
	DoD	26.03	19.23
	Non-DoD	29.29	20.82
Other Sponsored Activities	Navy	16.82	16.82
	DoD	26.67	17.63
	Non-DoD	26.67	17.63

Note: A comparison of PwC/Committee recommendations is provided as Appendix C.

3.2 Proposed Distribution of Indirect

3.2.1 Conceptual Basis for Proposed Distribution:

It is understood that the recovery of indirect costs (F&A) is reimbursement for costs that the university has incurred. OMB Circular A-21 provides guidance for the establishment

of the rate used for recovery of indirect. The distribution of the recovery is at the University's discretion. It is further understood that complete discretion of recovery would not be in keeping with the spirit of the previous NAVCOMPT guidance and that A21 is being used in this instance only as a guideline. The Committee recommends a compromise that will allow for the reimbursement of costs for infrastructure in support of sponsored programs, as well as investment in the individuals, equipment, organizational units and activities generating sponsored program funding at NPS.

The Committee proposes a distribution of indirect that acknowledges and provides for reimbursement or re-investment across the range of the university's resources:

Physical Resources:	Facilities, Laboratories, Equipment, Technology
Information Resources:	Library, Information Technology Infrastructure
Organizational Resources:	Administrative Structure, Processes and Systems
Programmatic Resources:	Instructional Programs, Research Programs
Human Resources:	Intellectual Capital of Faculty

The Committee additionally recognizes that the locus of re-investment activities is distributed throughout the university. Some examples include:

Superintendent/Provost:	Infrastructure, IT, Library, Central administration
Assoc Provost/Academic Admin:	Registration system, Python system, OCL, Instructional technology and support ; University education investment
Dean-Research:	SPO Administration, University research initiatives/investment
Schools/Depts./Institutes:	Faculty development, Instructional program development, Research program development, Dept administrative infrastructure, Classroom and research technology, Instructional support, Bid and Proposal; Research and Education Investment
Principal Investigators / Program Managers	Research equipment, Program bridge funding Instructional program, Course development

3.2.2 Proposed Distribution of F&A Recovery (FY05-FY06)

The following distribution is recommended:

INDIRECT COSTCOMMITTEE RECOMMENDED DISTRIBUTION					
RECIPIENT			**DISTRIBUTION PERCENTAGE**		
Associated Individual	Associated PwC Cost Pools	Organiza-tional Level	Instruction Indirect Distribution % of total	Research Indirect Distribution % of total	Other Sponsored Indirect Distribution % of total
Provost	Facilities: O&M + Lib	University	15	10	10
Provost	General Admin		12	10	10
Assoc Provost -Academics	Academic Admin		20	-	-
Dean-Research	Research		-	15	15
Sponsored Programs Ofc	Spon Program Admin		2	8	8
School Deans	N/A	School	5	3	3
Depts/Inst	Dept. Admin	Dept / Inst	41	34	34
PIs/PMs	Instruction/ Research	Program	5	20	20

Comments are necessary to elaborate on aspects of the Committee's distribution recommendations:

1. Library and IT: The existing NPS distribution formula explicitly directs a percentage of indirect to the Library and to Academic Computing. The Committee recognizes the continuing need for reinvestment into these university resources. In the PwC study and the Committee's distribution model, the Library and IT are subcomponents of the broader Facilities category, so the Committee chose not to specify a specific percentage distribution directly to the Library or IT. The Committee does recommend that indirect distributed for Facilities to the University (Provost) would be used to provide substantial reinvestment in the Library and IT.

2. *Investment Funds*: The Dean of Research, Associate Provost for Academic Affairs and the Department Chairs/Institute Directors have been provided funds for investment in the future of NPS. Of the distribution indicated above for these recipients, the following portion must be used for reinvestment that will be determined with the

assistance of a faculty advisory committee, i.e., in the case of research, the Research Advisory Board.

Dean of Research: 15% (10% discretionary; 5% faculty advisory)
Associate Provost for Academic Affairs: 20% (15% centralized support; 5% investment).
Chairs/Directors: 34% (24% support staff; 10% investment)

3. Departments/Institutes: The Committee recommends distribution to Departments and Institutes in a process analogous to the current distribution to Departments under the existing NPS Indirect model for support labor.

4. Principal Investigators / Program Managers: The Committee recommends direct return of a percentage of Indirect to PIs/PMs. Needs exist at the PIs level including reinvestment in research equipment and technology, maintenance of research capability, and bridging of research support for research personnel between projects. Additionally, indirect funds returned to PIs/PMs can be used as cost-sharing, permitting a reduction in project direct costs to the sponsor.

Note: An example of the effect of Committee's Recommended Rates and Distribution is provided as Appendix D.

3.3 Recommended Policies for Implementation: The Committee recommends that:

- Indirect costs be recovered against direct labor costs (faculty, staff and contract), using the proposed rates and distribution for a two-year period (FY05-FY06).

- That any significant modification to the Indirect Program would be preceded by:

  - A review of the actual indirect recovery and distribution experience by a faculty committee.
  - The completion of an appropriate space survey of facility use.
  - The development of an accounting process for the recording of MTDC.

3.3.1 Recommendations concerning the Administration of Indirect Costs

- Facilities and Administrative Costs (Indirect Costs) will be recovered from all NPS sponsored activities at the rate established/approved for the type activity.

- Facilities and Administrative Costs (Indirect Costs) will be a budgeted line item in all NPS proposals for sponsored activities. New rates will be included on all proposals submitted after 1 August 2004.

- Facilities and Administrative Costs Recovery will be reported bi-weekly to the institutional activity supporting the sponsored project and the recipient of the recovery.

- Indirect Cost Recovery Accounts will not expire at the end of the fiscal year; however the only allowable carryover will be the recovery from non-expiring accounts.

- Projects currently funded or approved for multi-year funding prior to the announcement of the FY05/FY06 rates will be grandfathered at the rates initially proposed. Projects proposed prior to the announcement of the FY05/FY06 rates will be grandfathered at the rate proposed for FY05. Subsequent years must bear the FY05/06 rates.

- Indirect distribution will be specified and attached as an internal document to all NPS sponsored program proposals.

3.3.2 Recommendations concerning Waivers and Exceptions

- The authority to waive all, or a portion, of indirect costs will reside with the Dean of Research for all sponsored research and service type proposals and with the Associate Provost for Academic Affairs for all sponsored instruction proposals. Possible reasons for waivers may include:

  - Law/Regulation/Sponsor Policy: When collection of Indirect is prohibited.
  - Strategic Marketing: When collection of Indirect is expected to price a program out of existence.
  - Double-Charging: When a project already charges a sponsor directly for cost items considered to be indirect cost items.

- Costs recovered directly on a sponsored project will not be duplicated in the Indirect Cost Recovery. Services will not be "double charged." Programs will buy services only once, e.g., in the case of major projects, department administrative support may be budgeted as a direct charge. In such cases, a portion of the recovery attributed to the department/institute admin would be "set aside" from the F&A rate indicated on the proposal.

- Indirect Cost Recovery will be waived for Gift Accounts and Student Fellowships.

- National Science Foundation projects will be afforded the Navy F&A rate if the ONR Program Manager provides a letter stating the NSF project supports a Navy goal.

- Program Managers stating that Library resources are not utilized by Distance Learning Students will coordinate set-aside of the Library distribution of the indirect rate with the Director of the Library. Program Managers will issue a letter to Distance Learning students stating that Library resources at NPS are not available for their use. Note: The committee has not recommended a distribution for the Library.

The Library's recovery is included in the Provost's distribution. The Library's portion will have to be determined.

3.4 Collateral Recommendations

The Faculty Ad Hoc Committee for Indirect Costs respectfully submits the following collateral recommendations:

- The effective Facilities and Administrative Costs recovered on sponsored programs will not negatively impact mission funding for operating target budget provided to departments/schools/institutes or other support functions receiving indirect cost recovery.

- Consideration will be given to fully funding the contractual period for tenure and tenure-track faculty. Fully funded contracts will bear an obligation for a predetermined teaching load and expectations for annual scholarly activities.

- NPS support processes will require further review to assure efficiency, not just additional cost.

- The organizational reporting structure for the Sponsored Program Financial Analyst will be reviewed in view of the growth in sponsored programs.

APPENDIX A

COMMITTEE APPOINTMENT MEMO

NAVAL POSTGRADUATE SCHOOL
Monterey, CA 93943-5138

NPS(01)
9 Apr 01

MEMORANDUM

From: Provost
To: Faculty

Subj: APPOINTMENT OF FACULTY AD HOC COMMITTEE ON INDIRECT COSTS

Ref: (a) NAVPGSCOLINST 7130.1A

1. Reference (a) governs the establishment and distribution of indirect costs at NPS. The current rate has been in effect since 1 October 1996. It is time to review the sponsored activities at NPS and review the current rate. This is very important in light of the growth in sponsored programs over the past few years.

2. A Faculty Ad Hoc Committee oversees the indirect cost proposal process. This committee will be comprised of representatives from the four Schools, an Institute representative, and an at-large representative. The following individuals are named to the FY01 Faculty Ad Hoc Committee on Indirect Costs:

School of International Graduate Studies:
Professor Jim Wirtz
Graduate School of Business and Public Policy:
Professor Joe San Miguel
Graduate School of Engineering and Applied Sciences:
Professor Ken Davidson
Graduate School of Operational and Information Sciences:
Professor Kevin Wood
Institute Representative: Professor Mike Zyda
Member-at-Large: Professor John Powers

3. The committee is expected to make its recommendation to the Superintendent's Strategic Planning Group by mid-July.

4. Questions and/or concerns should be addressed to the Dean of Research by e-mailing research@nps.navy.mil.

Richard S. Elster

RICHARD S. ELSTER

APPENDIX B

LETTERS FROM RADM ELLISON

DEPARTMENT OF THE NAVY
NAVAL POSTGRADUATE SCHOOL
1 UNIVERSITY CIR
MONTEREY CA 93943-5000

IN REPLY REFER TO:

7000
Ser 21/013
31 Jul 02

From: Superintendent, Naval Postgraduate School
To: Principal Deputy Assistant Secretary of the Navy (Financial Management and Comptroller)

Subj: CANCELLATION OF DEPARTMENT OF THE NAVY MANUALS

Ref: (a) ASN Memorandum of 24 May 2002
(b) NAVSO P-1000-3, NAVCOMPT Manual Volume 3: Appropriation, Cost and Property Accounting (Field) paragraph 035807-2h(3)
(c) NAVCOMPT ltr NCB-513 7130 of 26 May 1981
(d) NAVCOMPT ltr NCB-5 7000 Ser 20/451 of 18 April 1986

1. In accordance with reference (a), the Naval Postgraduate School is requesting to retain the subject guidance in reference (b).

2. Justification: Although primarily an Operations and Maintenance, Navy funded activity, the Naval Postgraduate School (NPS), by virtue of its status as an accredited university, is involved in a substantial amount of reimbursable work in support of its graduate education mission. This work is performed on a reimbursable basis for a number of customers, the majority being DoD activities. Because of this unique status, NAVCOMPT has previously granted NPS the authority to recover indirect labor and non-labor costs on reimbursable work performed per reference (c) and further expanded per reference (d). This authority was supported by a Comptroller General decision allowing that costs incurred solely for the purpose of performing reimbursable work may be recovered, provided those costs would not normally be incurred if the reimbursable work were not performed.

3. Suggested Language: The Naval Postgraduate School, Monterey, CA, remains exempt from this policy and is authorized to recover indirect costs incurred that are significantly related to reimbursable projects by means of applying an indirect cost. The total amount of these indirect costs applicable to each project, together with a brief explanation statement, will be stated in the reimbursable proposal submitted to the external sponsoring activity. The recovery of significant costs will be consistent with OMB Circular A-21 that states that these costs are incurrent for common or joint

Subj: CANCELLATION OF DEPARTMENT OF THE NAVY MANUALS

objectives and, therefore, cannot be identified readily and specifically with a particular sponsored project, a

mission instructional activity, or any other mission institutional activity.

4. Any questions regarding this request should be forwarded to Ms. Megan Reilly at (831) 656-2192/DSN 756 or e-mail mreilly@nps.navy.mil.

DAVID R. ELLISON

Cc: CNO N09B (FLDSUPPACT)

DEPARTMENT OF THE NAVY
NAVAL POSTGRADUATE SCHOOL
1 UNIVERSITY CIR
MONTEREY CA 93943-5000

IN REPLY REFER TO:
7000
Ser 00/087
7 May 03

From: Superintendent, Naval Postgraduate School
To: Assistant Secretary of the Navy (Financial Management and Comptroller)

Subj: CANCELLATION OF DEPARTMENT OF THE NAVY MANUALS

Ref: (a) ASN (FM&C) Memorandum of 24 May 02

Encl: (1) Superintendent, Naval Postgraduate School ltr 7000 Ser 21/013 of 31 Jul 02

1. Reference (a) announced cancellation of the Navy Comptroller Manual effective 30 September 2002. Recommendations to incorporate pertinent NAVCOMPT Manual information into the DoD Financial Management Regulation were solicited. In response, enclosure (1) was forwarded.

2. Enclosure (1) requested that the NAVCOMPT Manual's authorization of the Naval Postgraduate School's (NPS) recovery of indirect labor and non-labor costs on reimbursable research work be incorporated into the DoD Financial Management Regulation. It also requested that the authority be expanded to include reimbursable education. No formal response was received. Informal communication from FMB5 representative indicated that such authorization was extended to an unspecified future date.

3. Unless otherwise directed, NPS will continue to recover indirect labor and non-labor costs on reimbursable research. Additionally, applying the same analysis as that resulting in authorization pertaining to costs for reimbursable research, and recognizing that reimbursable education is an increasingly important component of the graduate education mission, and that non-recovery of indirect costs likely constitutes impermissible augmentation of customers' appropriations, NPS intends to initiate recovery of indirect labor and non-labor costs on reimbursable education commencing FY-04.

David R. Ellison
DAVID R. ELLISON
Rear Admiral, U.S. Navy

Copy to:
CNETC

APPENDIX C

RATE COMPARISON

PwC STUDY/COMMITTEE RECOMMENDATIONS

Components		Committee		PwC Study	
Activity	**Sponsor**	**On-Campus**	**Off-Campus**	**On-Campus**	**Off-Campus**
Research	Navy	21.59	19.43	23.59	21.43
	DoD	30.59	19.43	41.01	21.43
	Non-DoD	30.90	19.78	43.34	22.95
Instruction	Navy	19.23	19.23	39.80	32.00
	DoD	26.03	19.23	63.41	32.00
	Non-DoD	29.29	20.82	57.99	26.00
Other Sponsored Activities	Navy	16.82	16.82	19.67	18.82
	DoD	26.67	17.63	39.67	18.82
	Non-DoD	26.67	17.63	43.23	20.80

APPENDIX D

EXAMPLE EFFECT OF COMMITTEE'S RECOMMENDED RATES AND DISTRIBUTION

During FY2003, NPS recovered approximately $3.2 million of indirect on approximately $63.4 million of reimbursable programs. Distribution was based on the then existing NPS distribution formula. For illustrative purposes, the Committee created a model to retroactively determine the collection and distribution of FY2003 indirect had the Committee's proposed indirect rates and distribution percentages been in effect. Results from that model follow with a comparison to actual FY03 Indirect distribution.

HYPOTHETICAL FY03 APPLICATION OF PROPOSED RATES AND DISTRIBUTION					
RECIPIENT			**DISTRIBUTION PERCENTAGE**		
Associated Individual	Associated PWC Cost Pools	Organizational Level	Actual FY2003 Indirect Distribution ($1000s)	Hypothetical Distribution (Collection on Labor Base) ($1000s)	Hypothetical Distribution (Collection on MTDC base) ($1000s)
Provost	Facilities: O&M + Lib	University	744	1123	1701
Provost	General Admin	University	824	1062	1610
Assoc Prov - Academics	Academic Admin	University	0	401	601
Assoc Prov -Research	Research Office/SPO	University	259	1932	2928
School Deans	N/A	School	0	347	526
Depts/Inst	Dept. Admin	Dept / Inst	1406	3617	5480
PIs/PMs	Instruction/ Research	Program	0	1746	2646
TOTAL			**3,233**	**10,230**	**15,492**

The following table is another illustration, seeing what happens when an additional $10 million is added to the recovery base.

HYPOTHETICAL FY03 APPLICATION OF PROPOSED RATES AND DISTRIBUTION					
RECIPIENT			**DISTRIBUTION PERCENTAGE**		
Associated Individual	Associated PWC Cost Pools	Organizational Level	Actual FY2003 Indirect Distribution ($1000s)	Hypothetical Distribution (Collection on Labor Base) ($1000s)	Hypothetical Distribution (Collection on MTDC base) ($1000s)
Provost	Facilities: O&M + Lib	University	744	1410	2136
Provost	General Admin		824	1293	1959
Assoc Prov - Academics	Academic Admin		0	779	1181
Assoc Prov -Research	Research Office/SPO		259	1971	2986
School Deans	N/A	School	0	443	671
Depts/Inst	Dept. Admin	Dept / Inst	1406	4402	6669
PIs/PMs	Instruction/ Research	Program	0	1842	2791
TOTAL			**3,233**	**12140**	**18,393**

The hypothetical examples are based on some strong assumptions concerning the recovery of indirect:

- All projects are assumed "on campus."
- No waivers granted, so all projects provide indirect at full rates.

The conditions applied by these assumptions are not likely to be realized immediately, but the example is designed to illustrate rough magnitudes and proportions of indirect available if the Committee's model were fully implemented.

LIST OF REFERENCES

Department of Defense Instruction 4000.19 (1996). *Intraservice and Intragovernmental Support.*

Department of Defense Financial Management Regulation 7000.14 (2003).

Office of Management and Budget, (2000). Circular A-21, *Principles of Costs Applicable to Grants, Contracts, and Other Agreements With Educational Institutions.*

PricewaterhouseCoopers, (2004). *NAVAL POSTGRADUATE SCHOOL FACILITIES AND ADMINISTRATIVE COST PROPOSAL REPORT*.

United States Code, Title 31, section 1535, *The Economy Act.*
United States Code, Title 41, section 23, *Project Order Law*.

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INITIAL DISTRIBUTION LIST

1. Defense Technical Information Center
   Ft. Belvoir, Virginia

2. Dudley Knox Library
   Naval Postgraduate School
   Monterey, California